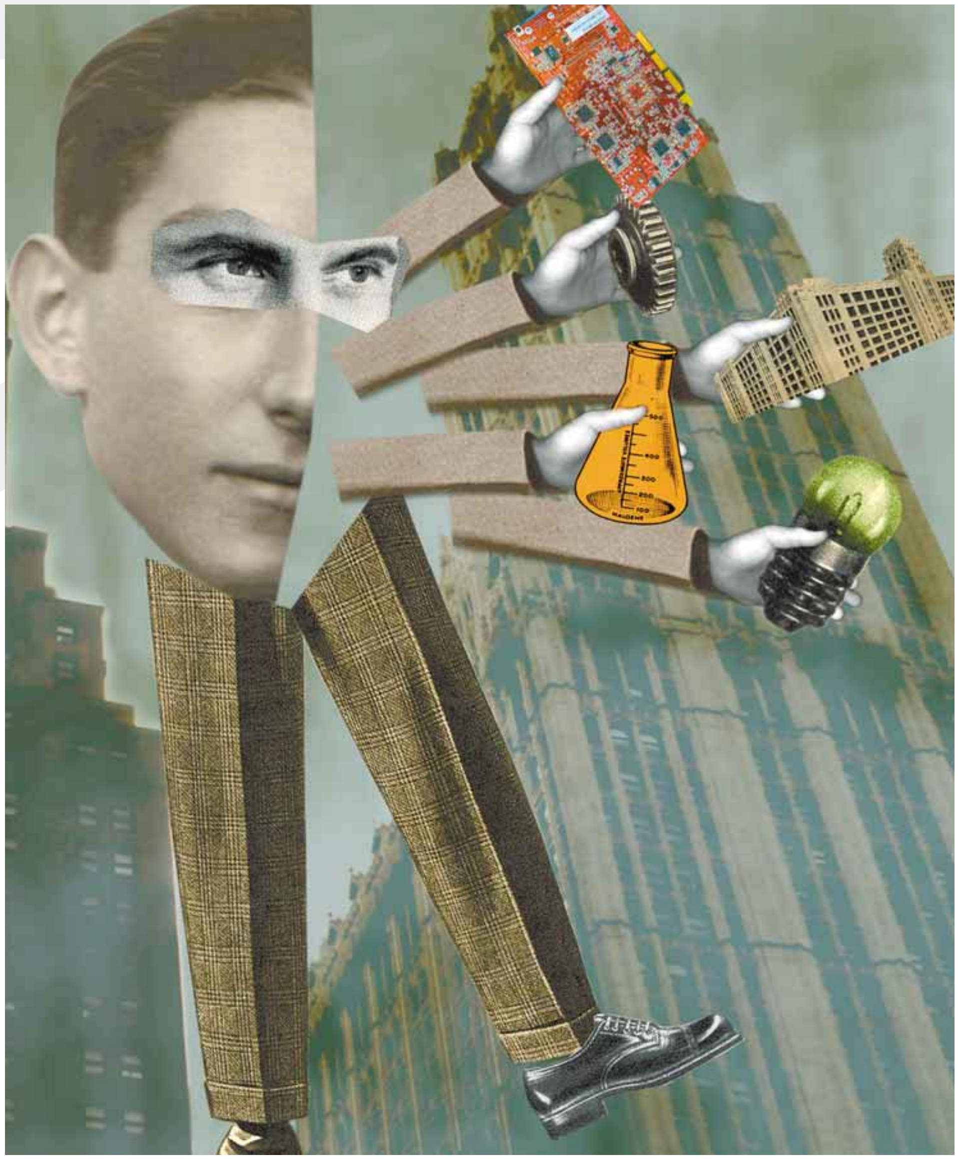
Getting a grip on alliance

Upgrading transparency and governance

by JAMES BAMFORD *and* DAVID ERNST

During the past decade, more and more companies have found joint ventures and other alliances to be attractive tools. There are now more than 300 joint ventures in the world whose annual revenues exceed $1 billion, including such giants as Thomas Cook AG, Cingular Wireless LLC and Fuji Xerox Co. Ltd. Many large companies hold 100 or more alliances in their portfolios and depend on such ventures for 20% or more of their assets, revenues or income.

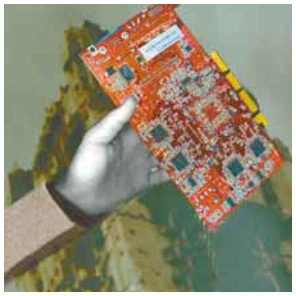
Yet alliances—which we define to include both equity joint ventures as well as nonequity partnerships—often disappoint. We have found that 50% of them fail to meet the financial and strategic objectives of the corporate parents—and that 47% of alliances diminish corporate share price at the time of announcement. One might ask: Is the continued use of alliances simply a triumph of hope over experience? We think not. Despite the hurdles, a JV or alliance may still be the best way—and is sometimes the only way—to accomplish a variety of purposes, from accessing skills and markets to building new businesses, from sharing risk and capital investment to driving performance improvement in existing businesses.



That leaves a great many companies still trying to figure out how to properly monitor their alliances and JVs and get them to perform as desired. Despite the 2002 Sarbanes-Oxley Act and new Securities and Exchange Commission and Financial Accounting Standards Board guidelines meant to improve transparency and accounting fairness related to third-party transactions, many companies continue to face challenges in developing a timely, accurate picture of the performance and risk profile of these economically complex entities.

The good news: There are a number of specific actions companies can take to upgrade the performance management of their alliances—and, as appropriate, to fix, restructure or even terminate ventures that don't fit the portfolio or don't meet performance expectations.

Before a company takes any of these actions, though, it will do well simply to recognize that alliances present managers with a number of natural hurdles. Monitoring true profits when the parents provide goods or services at various transfer prices to the venture—a rat's nest for many alliances—isn't simple. Linking the venture into the corporate reporting systems of two separate parents can be cumbersome. No wonder research has shown that 90% of all alliances lack sufficient performance metrics. One large industrial conglomerate, which like many companies had nonstandard reporting for its JVs, determined after an internal alliance audit that several of its major ventures were dramatically underperforming—delivering a 3% to 5% return on invested capital, a figure well below the 12% corporate hurdle rate.



With two parents, many JVs inherit a patchwork of systems, which may allow each parent to meet some minimum reporting needs but which aren't as robust as the systems seen in wholly owned business units. Even in large JVs, senior management may lack performance data that wholly owned business units take for granted (for example, detailed product and customer profitability). As a result, senior management often lacks the means to compare a JV's performance with that of other business units or external peers.

Then there's the reality that joint ventures and other alliances exist on the corporate periphery and therefore naturally receive lower levels of management scrutiny. Many companies have taken the noble idea of "venture independence" too far, overextending the often-legitimate desire to grant a venture real operating freedom and, in the process, reducing their ability to anticipate problems and step in quickly when they occur.

Finally, JV board governance is not as well developed as corporate governance. Board members may not represent a full mix of the skills needed for effective oversight of the venture, and they may be pressed for time given their other parent company roles.

Fortunately, these problems can be fixed. Based on our experience with more than 500 alliances, we believe companies should focus on several actions, including:

1. Improve alliance metrics and reporting systems. Though few companies seem fully aware of it yet, one critical implication of the new FASB Interpretation 46 guidelines is that a company must understand, in a holistic way, the overall economics of an alliance, to determine whether it is the "primary beneficiary" of the relationship. Gaining this understanding will require a fundamental change in how partners monitor their ventures, because they will need an accurate picture of a number of key factors in alliance economics that are outside the narrowly calculated profit and loss of a joint venture. These factors include other non-P&L gains from the venture (for example, transfer price profits on inputs, fees for services, etc.), tax benefits and option value such as the right to acquire a JV at a certain price.

Even more important, companies need to invest in management information systems at the individual venture level. Strong management information systems and finance organizations (either built within the JV or obtained through explicit access to resources in the parents) are essential to generating critical management-level data such as customer and product profitability and venture performance versus competitors.

To do this, one chemical company is considering the creation of a new unit reporting into the CFO, focused solely on monitoring major alliances and ensuring the company does not discover any more alliance surprises. Similarly, at a major aerospace company, every JV above a certain size must have a finance officer on its board, who reports to a senior vice president of the parent company.

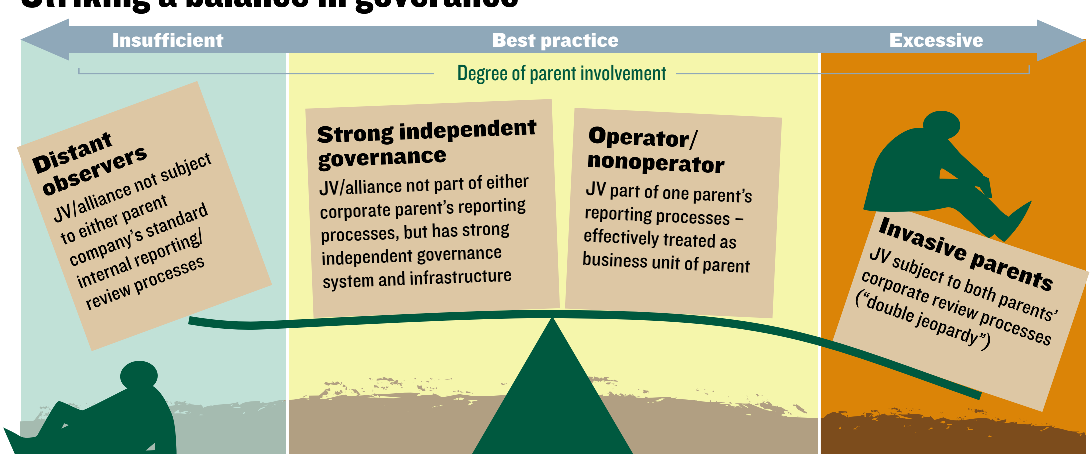
2. Set up a challenge process with teeth. Gathering performance data matters, but what matters even more is creating an environment where the corporate parents put it to use, actively probing venture performance and the underlying business assumptions. In joint ventures, this requires striking an unfamiliar balance. On one hand, the process must be rigorous and applied with consistency. On the other, it cannot be so invasive as to transform the corporate parents into "shadow" operators of the venture, thereby stifling the speed, authority and entrepreneurial spirit of the JV management team. Likewise, an effective challenge process should not squander the time of JV managers by subjecting them to the full, noncompatible reporting burdens of both parent companies.

How do companies strike this balance? One approach, seen in oil exploration JVs and elsewhere, is to allow one partner to be the operator, applying the same governance and reporting demands to the venture as it would to an internal business unit (see chart, page 30). Under this model, the nonoperating partner acts like a venture capitalist or strong financial investor—challenging venture performance but not creating its own reporting demands. Unfortunately, this model is unacceptable in many situations, because it requires one parent to turn over venture governance and operations to the partner.

An alternative approach is to build an independent governance model—that is, one where the parents are activist overseers but depend on a strong and independent venture governance system and review process to drive performance.

There are several keys to making this

Striking a balance in goverance



Source: McKinsey & Co.

model work. One is building the needed governance horsepower into the JV, including an audit discipline and systems normally reserved for public companies. The parents of one multibillion-dollar industrial joint venture, for example, created a separate audit committee of the JV board and actively used outside auditors to evaluate venture performance and parent company-related transactions. Another key is promoting a spirit of constructive confrontation on the JV board, a mindset where difficult questions are consistently asked rather than routinely avoided.

While the idea is to create a framework for independent governance, this does not mean that the JV management team should be totally delinked from the corporate parents. For example, at one $10 billion venture, the JV chief executive periodically attends the business unit strategy sessions of both corporate parents—a move that helps the JV remain visible to both parents and connected to their corporate strategies. While these meetings create important information flows, they are not part of the formal review process—for instance, the JV CEO does not present the JV strategy or budget to these groups, nor seek their formal approval for its plans.

3. Rethink the JV board's role and composition. Companies must also raise their game in other areas of alliance governance—most notably the role and composition of the JV board. For example, rather than define the JV board's responsibilities in very general terms, as is common practice today, companies would be much wiser to clearly differentiate between those governance processes where a strong parent hand is essential (for example, target setting, capital allocation and risk management) and those where less involvement is preferred (for instance, staffing, pricing and product development). This loose/tight approach to governance fosters operating independence while promoting strong oversight.

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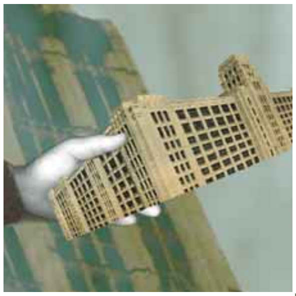
Companies should also rethink the selection of and demands on JV board members. JV board roles should be viewed as crucial financial and oversight positions, and board members should be selected and incented to bring focus, decision-making power and the right mix of financial and business skills to the venture. Yet most JV board members are not directly incented based on the performance of the venture and have limited time to spend in fulfilling their board roles. And again because of the overemphasized concept of JV independence, JV boards often haven't played the needed performance management role.



More than a decade ago, the California Public Employees' Retirement System led the charge in the U.S. to improve corporate governance, developing a set of guidelines that, in large part, centered on creating independent and accountable corporate boards. While the governance risks are different in JVs than in public companies, we believe that it is time for companies to take a CalPERS-like approach to challenging alliance governance conventions.

What might these guidelines look like?

• Joint venture boards should include outsiders, who bring objectivity and an advocate-for-the-JV mindset to meetings. Companies that have put outsiders on JV boards have enjoyed good results, even when the outsiders have had restricted voting rights.

• JV board members should have more specialized and accountable roles. One multinational company, for example, designates a "lead director" for each of its JVs and expects that director to spend 20 to 30 days per year working with the JV chief executive and serving as the first port of call.

• Boards should include executives who are senior enough to initiate the challenge process and resolve issues, rather than having to routinely seek approval from others inside the parent.

• JVs should in general have a nonexecutive chairman who shapes the board agenda and manages the governance process. This position could rotate between the parents every several years.

• Joint ventures should have parent finance staff embedded within the organization (for example, one or two people in the JV CFO's office) whose function is to manage risks and ensure transparency for the parents. Otherwise, JV board members have no source of primary performance information to challenge the JV management team.

4. Routinely reshape, restructure—or exit.

World-class alliance performance management also entails finding underperforming deals and changing their strategy, scope or structure to drive performance improvement—or terminating them when needed. Just like wholly owned business, all joint ventures need to evolve over time. Yet many companies suffer from a special kind of inertia when it comes to their alliances.

The value in fixing alliances can be sizable. Consider a U.S. media company. Under pressure from Wall Street to improve earnings, the company conducted a quick performance diagnostic of 13 key alliances in its portfolio—a scan that led to focusing on four underperforming ventures deemed to have the greatest chance for positive restructuring. The company ended up making changes to two of these alliances, capturing more than $600 million in net present value. Or consider a manufacturing JV in the natural resources industry. Here changes to the governance model of this one alliance unlocked $1 billion in performance improvements for the partners.

To capture such value, companies should start with a review of the 10 to 15 most important alliances in the portfolio. Done well, such a portfolio review will quickly assess each major alliance in terms of financial performance and fit with corporate strategy. Based on this information, managers will likely discover at least a few alliances where there seems to be both a need and an opportunity for substantial restructuring or for termination.

Once these underperforming alliances are identified, managers should diagnose the problem, assess a range of restructuring levers and evaluate the potential upside, costs and constraints of restructuring the venture. Once the company has a sense of what levers to pull—and the appropriate sequence—it then needs to determine how to approach the partner and implement the restructuring.

As a general rule, it pays to engage the partner early. One of the most common mistakes is for one side to spend too long analyzing the problem or mapping the solution in isolation—only to be blocked or dramatically redirected by the partner's reactions. Top performers also err on the side of overinvolvement, especially when making organizational changes. For example, in the relaunch of a major pharmaceutical alliance, the processes actively involved more than 300 people. These people, who were the members of the 20 alliance working teams, were responsible for improving decision-making processes, creating new "charters" for each working team and mapping peers in the partner organizations to increase transparency.

A decade ago, Peter Drucker wrote, "Today businesses grow through alliances, all kinds of dangerous liaisons and joint ventures, which, by the way, very few people understand."

Since then, companies have learned a lot about alliances, but there is still work to do in upgrading the performance management of joint ventures. It is time to change this. CD

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